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Are Prepayment Penalties an Impediment to Your Growth?

The Dilemma….. Currently, many franchisees are experiencing difficulties in meeting the requirement set out by their franchisor for redevelopment of their older stores. Most franchisees do not have the reserves to pay for a redevelopment of their assets out of pocket. Therefore, many times the only way to pay for redevelopment is by pulling equity out of their business through a refinancing of their current debt. Unfortunately, many franchisees are prevented from refinancing their current debt because they would incur large prepayment penalties and or "make-whole premiums" in their loan agreement. These extra expenses are usually so costly that it makes a refinancing impractical. If a franchisee does not redevelop, he or she incurs the risk of being defaulted by their franchisor for non-compliance with their franchise agreement, declining sales or losing market share to competitors. What does a franchisee do in this situation and how did things come to this in the first place?

First a little history lesson… During the fast money days of the 1990's, banks were aggressively bidding against one another to loan money to the franchise industry. Interest rates were higher but many lenders were financing 100% of the acquisition including closing costs. This made it very easy for a franchisee to buy into a concept or expand their current operations. To further complicate matters, many industry experts expected franchise sales to continue to grow for a long time. This misconception helped inflate the value of the assets being acquired by the franchisee, thus putting him in a position to be over-leveraged if sales ever fell from their historic highs. After the loan was funded, many lenders sold the loan to the investment community, which were pooled with other similar loans. At that time, interest rates were high and investors were clamoring to invest in pooled loans to lock in interest rates of 9-10% for 15-20 years. These investors could finance a large portion of their investment and increase their returns on equity to 20-30%. In order to protect and insure returns to the investors over the term of the note, the loans had prepayment penalties to guard against any decline in interest rates in the future. Another term for insuring investors' return was the "Make-Whole Premium." Depending on the gap between the rate at time of refinancing and the locked rate, make-whole premiums could run into the millions of dollars for most franchisees. This hidden cost was merely overlooked by the franchisees as they never expected to refinance before the loan term expired. On the other hand, investors who bought the loans had the comfort of knowing they had locked in 15-20 year returns at attractive rates.

Current Market Environment…. However, the financial world has changed dramatically. During the present time frame, rates have now fallen to historical lows. Variable rates are typically 300 basis points over the 1-month LIBOR (6.5%) and fixed rates are in the 7.25-7.5% range. This means that franchisees that are looking to refinance their loans at the more attractive rates of today have to pay huge sums of money for prepayment penalties. For most franchisees, this is not money they can tap from their cash flow or from refinancing their loan. At the same time, franchisees are losing hundreds of thousands of dollars on debt payments each year versus what they should be paying in the current interest rate environment. Franchisees find themselves in a terrible quagmire where they need additional cash flow to pay for rising fixed expenses and capital upgrades but are unable to refinance their debt because of these expensive prepayment penalties. The capital upgrades are typically franchisor-mandated with dire consequences for the franchisee if they do not meet their deadlines. The franchisees are confronted with two choices; lose their franchise if they cannot meet their capital schedule or incur expensive prepayment penalties to refinance their debt, which in most cases leaves no money for capital expenditures. Either option is unacceptable and potentially lethal to your business. This is a growing concern that is sweeping across the franchise industry and it has the potential to put a lot of franchisees out of business.

Time to Take Action… It is our belief that franchisees need to take action and confront this issue sooner than later. Interest rates are beginning to rise again and time is of the essence when it comes to refinancing your existing debt. Rates are still at historical lows. However, the window of opportunity is small. The capital upgrade requirement of most franchisors is mandatory and has significant repercussions if franchisees do not meet their deadlines. Not to mention the fact that upgrading your image has generally proven to increase sales dramatically and allows you to effectively protect your market from competitors. Our company, **MarshallMorgan, LLC** has helped many franchisees out of this dilemma. As a result of our efforts, our clients have been able to meet their capital upgrade schedule and refinance their debt with attractive rates. Our strategy has taken many franchisees on the brink of default to a mode of growth, new development and acquisitions. We have represented franchisees with several million dollars of prepayment penalties and have been successful in obtaining complete or partial waivers on this obligation. Obviously, each franchisee’s situation is different and there can be no guarantee of results but MarshallMorgan has a high record of success in helping its clients achieve profitability and growth for the future. It is our belief that unless these onerous and expensive debt obligations are removed, the franchisee has the potential of declaring bankruptcy and the value of the loan to the lender is worth far less than a workout.

We Can Help! MarshallMorgan, LLC is a firm comprised of financial and legal experts that have worked for and with Yum Brands, Blockbuster Entertainment, FDIC, West Coast Entertainment, and Exxon, amongst other large corporations. This company has primarily represented franchisees and has earned a reputation in the industry of coming up with long-term permanent solutions for its clients. Some of the lenders that we have experience with on negotiating prepayment penalties include GMAC, Amresco, Finova, AMC, Captec, Peachtree and Bank of New York.

Please feel free to visit our booth at the upcoming Franmac Convention in Hawaii.